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A LOOK AHEAD AT THE WORLD OF COMPETITIVE COMMISSION RATES

An Address by

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Securities and Exchange Commission

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This is an historic occasion, being the first organized effort within the securities industry to hold a public discussion of the legal and practical aspects of pricing policy for brokerage services in a fully competitive environment. Mike Tobin and others at the Midwest Stock Exchange are to be commended for taking this initiative, and I am glad to be a part of the occasion. Because of our desire to be as well informed as possible on this whole matter, Sheldon Rappaport, an Associate Director of our Division of Market Regulation, is attending all of these sessions, and I really wish that I could do the same.

We at the Commission are fully aware of the enormity of what is being thrust upon the managers of broker-dealer firms. All of us have grown up under the shelter of fixed commission rates as one of the immutable propositions in the financial universe. Despite the many years of public debate, Congressional studies and litigation in which this immutableness and even propriety has been severely challenged, many of you I know were both emotionally and practically unprepared for moving in this direction. Some of you from the larger firms can afford the technical staff within your own ranks to make studies and plans in this area. Some such firms I know are well advanced in their planning. But many of you do not have these kinds of resources, and you need help as well as encouragement. Seminars like this are most valuable for that purpose. Not only must you now master pricing strategy and policy, but also you must now become familiar with our antitrust laws as they may relate to these matters. As you no doubt have learned and are learning, certain folkways which are well engrained in the members of the broker-dealer industry are going to be sources of danger in the world to come.

I am glad, at last, to be at a gathering devoted to constructive thinking about how to live in the world of the future, rather than to plotting and dreaming to recapture the world of the past. Since it seems unlikely that I can advance your understanding of how to cope with the forthcoming problems, and perhaps inappropriate for me to try to in any event, I should like to devote the rest of my remarks this noon to a summary of how we got where we are and why, with a special emphasis upon the most recent development with respect to the experimental period from April 1, 1974 to April 30, 1975.

When I joined the Commission last August, hearings were just being completed on the New York Stock Exchange's proposal to increase minimum commission rates by ten percent on orders up to $5,000, and fifteen percent on orders between $5,000 and $300,000. At that time, the Commission was operating under its announced policy of approaching competitive rates from the top down, so to speak. These already had been several years experience with the unfixing of commission on that portion of brokerage orders about $500,000 and some two years experience with unfixing about $300,000. Although the Commission had announced its intention of moving from $300,000 to $100,000 by the spring of 1974, with the possibility of an interim decrease to $200,000 by the spring of 1973, any interim step had been rejected and the move to $100,000 was still pending. Also at that time, there was legislation pending in the House of Representatives which would have written into law the ultimate elimination of all fixed commissions by further graduations to $200,000 and then to $100,000. There was also pending, as indeed there still is, litigation challenging the legality of fixed commissions, with the Antitrust Division of the Department of Justice urging that fixed commissions were in violation of our antitrust laws and urging a federal court to adopt a forced phase-out ultimately eliminating all fixed commissions by mandatory injunction. While the Commission was steadily moving the securities industry toward unfixed rates, we opposed this lawsuit, as we still do, because of its intereference with our administrative responsibilities.

During most of the several weeks between my announced appointment and my swearing-in, and for some weeks thereafter, I did very little else but read background material from the Commission's hearings, the Congressional studies and other literature on the whole question of fixed commissions. I had entered the subject with the rather strong feeling that a practice that had lasted for almost two hundred years must be sound and should not be declared improper.

But the more I studied the various arguments on the question, and the more I contemplated the problems of continued and intelligent rate-fixing in this area, the more apparent it became that this well-established custom would no longer be desirable under the conditions and state of the industry we could envision. Al Sommer, who, of course, joined the Commission at the same time I did, went through a similar educational process in an effort to catch up, so to speak, with the Commissioners and staff who had been considering this matter for some time.

At the same time, the broker-dealer industry was approaching a new crisis of monstrous proportions: the low state of the market; low volume; inventory losses; and the various factors which had driven or lured individual investors away from our stock markets to other forms of investment; all combined to make it evident that something had to be done.

Our resolution, as you know, was not to object to the implementation by most of the exchanges of the full increases requested by the New York Stock Exchange, although we felt it appropriate to advise the exchanges that this increase would be followed by the termination of the whole rate-fixing business on a day certain, approximately eighteen months later. We thought the industry needed time to prepare for the unfixing of commissions by the holding of seminars such as this and other study and planning operations and, for the same reason, we decided that there should be partial experimentation toward the unfixing of commissions beginning this coming April.

It would be an understatement to observe that not all members of the industry have applauded our decision. Much of my mail, many conferences in my office and at lunch, and much of the question period at any public appearances that I have made, have been devoted to hearing impassioned pleas by brokers to the effect that we are destroying the industry. One friend observed that the other Commissioners and I were going to put him out of work and ourselves as well, since we would shortly have no industry left to regulate.

It is not always easy to remain calm and steadfast in the face of such pleading. I know that all of the persons that think we are wrong are not greedy or lazy or antediluvian. Some of them are the most statesman-like thinkers and figures in our whole financial community. I have to say to such concerned and thoughtful persons that I think they are wrong and that we are right, even though this takes a degree of temerity that I am not generally inclined to display. You can understand, therefore, that I read with some satisfaction the report of Professor Lorie to Secretary Shultz of the Treasury, recently published as “Public Policy for American Capital Markets.” In a very strong statement on the subject, Professor Lorie states:

> “The SEC’s current policy of requiring fully competitive rates after April 30, 1975, is admirable. There will continue to be strenuous efforts by opponents of this policy to have it reversed. Some will say that the spring of 1975 is not ideal, because no time will be ideal for making such an important change. Nevertheless, competitive rates are the only rival to the new systems of communications [meaning the proposed central market system] in their promise of benefits both to the financial community and to the general public.”

In announcing our intention with respect to the total unfixing of commissions after April 30, 1975, we necessarily abandoned the Commission’s former policy of encroachment or creeping down on unfixing with progressively lower ceilings. We did not, however, completely abandon a policy of gradualism or at least of experimentation. It seemed unwise for the industry to remain with fixed commissions up to $300,000 until the the dread date and then abandon them altogether at the same time. Our thought was to encourage a period of experimentation during which the industry and its members could get used to the idea and try out different devices without exposing their entire commission revenue to the hazards of the initial experiments. Our initial thought in this direction last September was to limit the experimentation to a percentage discount from the fixed commission rate rather than to size of order. This appeared to have the virtue of permitting experimentation across-the-board with all types of orders rather than limiting it to orders above or below a certain size. Since we did not have in mind simply an automatic ten percent discount from the increase being approved at that time, we suggested that the discount be related to the elimination of some service.

While this suggestion was greeted with some enthusiasm at the time, as weeks passed we encountered more and more puzzlement on the part of representatives of the industry and exchange staffs who were trying to put the suggestion into concrete form. This led to some informal conferences which persuaded us that the industry was likely to end up with simply an automatic discount, at least for all institutional customers - - a result that we certainly did not want to produce - - and that an effort to relate the cost of the elimination of any specified service to a reduction in commission rates was not apt to be realistic.

It may be quite realistic to establish a price schedule which does vary according to quantity or types of services rendered to customers but, when one starts with a fixed commission rate, and then attempts to reduce the commission rate dollar-for-dollar by the cost of the eliminated service, the result may not seem very satisfying in the present state of cost accounting in the industry.

Accordingly, in our letter of December 14, setting forth the bases for the policies we had announced the previous September, we did not insist upon the "ten-percent-discount-for-unbundling" approach, but we did adhere to our objective that there be a meaningful experimental period prior to the introduction of a system of completely unfixed commission rates, and we urged the exchanges to assume the initiative for the development of a program fostering limited price competition during this period.

With this background, the Commission has responded favorably to a proposal from the New York Stock Exchange to substitute fully unfixed rates on small orders for the ten percent permissive discount on all orders involving up to $300,000, as we originally had proposed. A prime question was whether completely unregulated pricing on small orders would serve as a better pilot project for gaining experience with fully competitive rates than would a partially regulated system of partially unfixed rates on all orders. The answer to that has become clear enough for us. We favor the former.

The next question was what should be considered a small order for purposes of this experiment. We reviewed data in our files from the NYSE Transaction Revenue Surveys ("TRS") concerning the member firms' commission business in all markets. It was supplemented and generally confirmed by additional data obtained by the New York Stock Exchange from a number of its member firms.

The TRS data showed the proportion of the commission business done by member firms in the first and last quarters of 1971 and the first quarter of 1973. While there were some differences over the different time periods involved, they were not substantial and, most important, the pattern of the distribution curves were similar. The data showed that in the first quarter of 1973, slightly under eleven percent of all commissions from all markets, and forty-two percent of all orders, were in the under $2,000 category. For the fourth quarter of 1971, a little over twelve percent of commissions from all markets were derived from orders of less than $2,000.

Further breakdowns were available to us for the fourth quarter of 1971 by category of firm. For retail firms - - defined as those with an average order size of less than 300 shares - - slightly more than 16-1/2 percent of commission dollars were derived from orders under $2,000. For intermediate firms - - those with average shares per order between 300 and 1,249 - - about 3-1/3 percent of commissions were derived from orders involving less than $2,000. For institutional firms - - those with an average order size of 1,250 shares or more - - the amount involved was a fraction less than one-half of one percent. We were also able to review 1971 fourth quarter figures for a sample of ten regionally-based firms. For this group, 14-1/3 percent of this commission income, and 47 percent of all commission orders, came from the under $2,000 category.

It seems obvious from these data that a much higher proportion of orders than income is derived from small orders. For purposes of this experiment, however, the total commission revenue exposed to unfixing seemed more significant than the number of orders. One reason for this is that any imaginable cutoff point would have involved a large number of orders. For example, a $1,000 cutoff would have involved about 24 percent of all New York Stock Exchange member firms' orders and 27 percent of the ten sampled regional firms' orders. Whatever cutoff point is adopted, therefore, the broker-dealer will have to post rates or otherwise explain to all customers what the charges are on small orders which will be subject to unfixed rates. Whether this is 24 percent or 42 percent of the number of orders should not matter much, as long as the aggregate commission revenue exposed to the experimental process is not unduly excessive. With a $2,000 cutoff, for retail firms as a whole about 15 percent of such revenue should be exposed, and there should be no substantial reduction of income on such orders. There could well be a net revenue increase overall, inasmuch as we have agreed to the removal of the ceiling on orders above $2,000.

The Commission also considered that a fully competitive rate experiment on small orders would give brokers seeking to attract periodic savings from small investors a better opportunity to compete for that business with banks and others who have not been inhibited by the anti-bunching strictures of exchange rules. We applaud and seek to encourage the member firm community's desire to compete for this business.

One who learns to swim starts out at the shallow end of the pool, but he must get in more than knee deep. We think a $2,000 figure cutoff represents sufficient depth for the member firm community's forthcoming lesson in pricing and services. We do not believe that it is so deep a plunge that it will confront you with a sink or swim, live or die, alternative.

In considering the effects of moving to a competitive rate system on the structure and profitability of the securities industry, it is important that we avoid attributing to the forces of price competition - - most of which is yet to occur - - all of the misfortunes that befall the securities industry during this period. In the past, as competitive rates were first introduced on transactions above $500,000, and later above $300,000, it was commonplace to attribute to the introduction of this competition much of the lack of profitability in the securities industry. Indeed, some still hoping to avoid the uncertainties of a fully competitive environment are tempted today to point to the unprofitable state of the securities industry in most of 1973 as evidence of the lack of wisdom in an economic policy which embraces price competition rather than price regulation.

In fact, as we all know, in 1968, 1969, and 1970, the securities industry went through a period of management and financial problems so severe in nature that their after-effects are still very much with us. A system of fixed rates did not protect the industry or the public from these problems during this period, and it is more likely that the fixed rate system substantially increased their severity. We found out, in those terrible days, that fixed rates cannot protect the securities industry and investors from losses and liquidations associated with a 40 to 50 percent decline in demand for brokerage services.

The Commission does not share the belief that the introduction of competition was the cause of past losses or that its further introduction would be the precursor of future losses. Figures developed by the New York Stock Exchange, in the course of our joint monitoring of the impact of competitive charges, show that, under competitive conditions, institutions were able to obtain discounts averaging roughly 30 percent on orders totalling $500,000 or more. People do not always recognize that this is the part of the commission rate schedule where competitive forces are extremely strong. In fact, they are so strong that they tended to operate irrespective of rules purporting to fix minimum charges. The operation of normal profit incentives in the brokerage industry effectively limited institutions to 30 percent discounts on giant orders without the support of a protective commission rate rule.

In the second phase of the introduction of competitive rates, when the breakpoint for transactions subject to competition was lowered to the level above $300,000, the average discount obtainable by institutions for orders subject to competition dropped to approximately 23 percent. In fact, the discount institutions were obtaining on orders between $300,000 and $500,000 approximated only eight percent.

These were the big steps in the introduction of competitive rates. They were big because of the uncertainty as to just how competitive forces would operate in the industry; and, more particularly, how they would operate in that part of the commission business where competitive forces could logically be expected to be the strongest. What then were the total impacts as best they can be measured on the revenues of securities firms of these first two steps in the introduction of competitive charges?

In the first phase, with orders that accounted for approximately 8.2 percent of revenues exposed to competitive forces, total securities commission revenues were about 2-1/2 percent less than they would have been under the old fixed rate schedule. In the second phase, when the breakpoint was lowered from $500,000 to $300,000, and an additional 4-1/2 percent of revenues were exposed to competitive charges, total commission revenues were one-half of one percent less than they would have been had that second step not been taken. To what extent firms were unable to adjust their costs and methods of operation to offset these reductions in revenue cannot be determined, although, when one remembers the extensive reciprocal activities that were engaged in prior to competitive charges, it is unreasonable to assume that all of these reductions in revenue were carried down to the bottom line.

You, as managers in the securities industry, have shown that, in dealing with your toughest customers, you have the strength and belief in the value of your services to charge what they are worth and what is needed to profit from those activities. You have not yet demonstrated that as managers you can price your services to the millions of small investors in a way which is most profitable to you and to them. Although the Commission has no corner on crystal balls, we sometimes feel that we do have a corner on confidence in the innate ability of the securities industry and its present younger and highly professional management. It is this confidence in the ability of the present managers of securities firms to adapt to the unfixed environment of the future that gives me excitement and hope for the new capital markets that we are creating.

There is one further thought that I would like to express. In contemplating the future of your industry, it is essential that you keep in mind the fact that many things are changing. While it is perfectly natural, in thinking of the new unfixed world, simply to take last year's revenues and recalculate them on some assumed unfixed commission basis, the pro forma effect may be quite misleading. The unfixing of commissions is not occurring in a vacuum.

I appreciate the possibility enervating effect of having to consider too many fundamental variables at the same time. Nevertheless, the reality is that many fundamental things are in the process of being changed concurrently. An obvious instance is the proposed consolidated tape. This has been somewhat slow in developing, and those who expect to make the best gains from its implementation have become impatient, but the important thing is that it is now moving forward. The spirit of cooperation and accommodation displayed by all participants in the consolidated tape has been most encouraging, and more recently we have been especially pleased with the constructive attitude shown by the leadership of the New York Stock Exchange and its Board of Directors. There is now every reason to expect that the consolidated tape will be in full operation before the full unfixing of commissions on April 30, 1975.

While the consolidated tape is about to become a reality, important developments are also occurring with respect to the development of a truly national clearing system. Whether this will ultimately take the form of a single unified system, or interfaced locally autonomous units, is uncertain; but the important fact to keep in mind is that there will surely be an efficient national clearing system before too long. Similarly, with respect to depositories, details in this area must also still be resolved, but there is every reason to expect that in the fairly near future there will be a national, interfaced system of depositories that will drastically reduce, if not altogether eliminate, the paper-shuffling that has been characteristic of our stock transfer system.

The development of a full-blown central market system, with a composite quotation system and the equal regulation that must accompany it, are somewhat further down the road. Still, they are within sight, and we can anticipate within a reasonably short period of time the central market system that takes full advantage of all of modern technology for the establishment of competitive market systems on a completely integrated basis, giving full advantage to public orders' priorities and preferences.

I urge you to keep this full program in mind. All aspects of the total program interrelate, and we are confident that the final effect will be a better stock market than we have ever known before, with transaction costs drastically lowered, access to markets sharply improved, and investor confidence and participation better than we have ever known.